MICHAEL J. MURPHY
State Treasurer

Spring 2005

The LOCAL View

Local Option Capital Asset Lending

What do elected officials need to know?

by **Michael J. Murphy**
Washington State Treasurer

As an elected official myself, I can understand how it might be hard to keep a straight face when you hear an office-holder say, "I'm here to help."

As easy as it is to be cynical, the elected councilpeople and commissioners of your entity really can be helpful to your finance programs – with your help.

You can make it easier for them to give you support. They might be new to office or they might not seem interested, but for whatever reason they might not know much about your debt program, including LOCAL.

Answer this question: Can I answer THEIR questions?

Explaining debt
Your debt program is a team effort. Get the elected officials on your side by letting them in the game. Make sure the mayor or commission chair understands his or her role on the team alongside the treasurer or finance director, financial advisers and bond counsel.

Many, if not most, elected officials are not finance professionals. Do not expect them to be instantly up-to-speed on the many details of your debt programs. Their decisions will be more likely to work in your favor if they understand what you do and why.

Explain to them the differences between bonds and COPs (and while you're at it, let them know what a great program LOCAL is). Explain the mechanics of debt (bond structure, timelines, repayment of debt, official statement preparation, regulatory requirements, etc.).

Your elected officials will be reassured to know you have a debt policy. They will be even happier if they have a role in crafting your debt policy before they are asked to give it a stamp of approval.

What are some other roles for elected officials in your debt management program?

They can be very helpful with your rating agency presentations.

They can be out front with you when you are selling your capital programs to the public.

A well-informed public official will be more willing to sign off on critical documents.

As for LOCAL, we at the Office of the State Treasurer are more than willing to help you explain the program to your elected officials. Don't hesitate to contact me or any of the staffers listed in this newsletter.

As an elected official, I know there is no such thing for a public official as being too well-informed.

What should we tell our elected officials about debt?

- How you use debt effectively
- The mechanics of debt
- Debt policy
- Regulatory requirements
- How they can help

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Understand refundings before you leap

by **Susan Musselman**

Many of you have received calls from underwriters notifying you of the opportunity to refinance outstanding bonds, some issued as recently as 2002. Most of the time you are told that you really must act now, before you lose the opportunity!

That may be good advice, but some important questions for you are "what do you really know about refunding bonds?" and "do you understand your options and alternatives?" Should you rush into a refunding, and if so, what parameters should you set? Can it all really be this easy, or are there questions you just don't know to ask?

First, let's review: There are two types of refinancing in the municipal bond market: a "*current refunding*," which is one that is accomplished <u>on or after</u> [1] the first optional redemption date on your bonds, and an "*advance refunding*," which can be accomplished <u>in advance of</u> the first optional redemption date on your bonds.

Through a current refunding, the issuer will achieve immediate debt-service reduction by issuing bonds in the current market, and using the proceeds to immediately call and redeem the outstanding bonds – much like a mortgage refinancing on your home.

While an advance refunding allows issuers to lock in current market interest rates (therefore debt-service reductions), the bonds being refunded cannot be redeemed until a future date. An advance refunding requires that an escrow be established to hold bond proceeds to provide for bond payments until the first optional redemption date.

In accordance with the Tax Reform Act of 1986, municipal bond issuers are limited in the ability to issue advance refunding bonds. First, only governmental purpose bonds can be advance refunded. And, significantly, your bonds can only be advance refunded one time. This means, if you issued bonds in 1992 and refunded them in 1996, you may not advance refund the 1996 bonds ever; although, you can wait until the call date – or 90 days prior – and current refund the 1996 bonds, assuming the right market conditions. There is no limit to the number of times you can issue current refunding bonds, but your optional redemption provisions typically make multiple current refundings impractical.

Things to consider about refunding bonds:

1. Extension of the call date. When you refund bonds, the new refunding bonds generally have a 10-year redemption provision.

Let's say you have bonds that were issued in 1998 and they are subject to optional redemption in 2008. If you refund those bonds in 2005, they will generally be subject to optional redemption in 2015. For many issuers this is just fine – you lock in savings in 2005, extend the redemption date, and it does not affect you whatsoever, because you have every intention of paying the bonds only as scheduled.

For other issuers, this may not be a good trade-off, as you may be planning to redeem the bonds on the first possible opportunity. Maybe you are considering selling the facility to a private party in the next couple of years, or you want to enter into a management contract with a private operator – having a shorter redemption provision may provide you with more economic options for redeeming bonds versus defeasing bonds.

Should you rush into a refunding, and if so, what parameters should you set? Can it all really be this easy?

2. Impact on reserve account earnings. When you refund bonds that have a reserve account requirement, you will reduce both the debt service on the bonds, and the amount of the required reserve account. That is fine for most issuers – many of you are earning less on the reserve than you pay on the bonds, so reducing that requirement will be a plus.

For other issuers, you may have an investment that is locked into an interest rate equal to the bond yield, and you are able to keep those earnings. When you refinance the bonds, you reduce the allowable investment yield on your bonds, requiring you to break your investment and reinvest at lower yields, or requiring yield reduction payments.

In a recent case, the lost earnings from the reduced yields were nearly half of the amount of savings – in other words, you may save on bond

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Quick fact

In the first three months of 2005, LOCAL helped 11 local governments finance 10 equipment projects and one real estate project for a total of more than $2.6 million.

Come see us

LOCAL representatives will staff booths at these upcoming conferences:

Washington Municipal Treasurers Assocation
April 13-15
Chelan

Washington Assn. of School Business Officials
May 11-13
Tacoma

Association of Washington Cities
June 21-24
Tri-Cities

Washington Finance Officers Association
Sept. 13-16
SeaTac

Refunding bonds

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debt service, but some of the savings may be off-set by the lower investment earnings. This will not apply to everyone, but if you have a high-yielding investment (typically an investment contract), you should ensure that your banker or financial adviser take the reduced earnings into account as an off-set of savings.

3. Moving down the yield curve. All things being equal, you will always have better results with a current refunding than an advance refunding. Now, read that again: "All things being equal . . ."

We do know that all things are not going to be equal, but hear me out. Remember that you only reduce interest on bonds that can be called – if you cannot call and replace a maturity, you cannot reduce the interest rate on that maturity. Assume that you issued bonds in 2002 for a 20-year term, with a 2012 call date. In 2005, the 2013 maturity is 8 years away, and the 2022 maturity is 17 years away; if you wait until 2012 to issue current refunding bonds, the 2013 maturity will be 1year away and the 2022 maturity will be 10 years away. Now, think about the yield curve. Today, the interest rate on a 1-year maturity is 2.5 percent and the interest rate on an 8-year maturity is 3.8 percent; interest rates on a 10-year maturity is 4.0 percent, and the interest rate on a 17-year maturity is 4.40 percent. When borrowing at the shorter end of the yield curve, you typically borrow at a lower rate.

4. Negative arbitrage in the escrow. Assuming that you understand the point about moving down on the yield curve (and if you don't, you can give me a call or discuss it with your financial adviser), you may think it is a fair and fine tradeoff to lock in known interest rates eight years before the call date. But, if you are not able to achieve the allowable yield in your escrow account, you are diluting those savings; at times this dilution is very, very large, and you may not be aware of its impact on your overall results.

The reason advance refundings work and make sense is that you are able to lock in low, current market interest rates today, to replace bonds that can only be called in the future. By investing the refunding proceeds in an escrow, at the bond yield, you theoretically have no "cost of carry." You borrow today, invest the proceeds at the same rates as the borrowing rate, the net cost is zero. (Theoretically – because the allowable investment rate does not take into account all of your borrowing costs, the escrow cost or the verification cost). If you are not able to invest the proceeds at rates equal to the allowable investment rate ("negative arbitrage"), you are eroding the benefit of the refinancing, and leaving "lost opportunity" on the table. When you lock in the refunding bonds and related escrow, you are forever giving up the opportunity to capture any of the negative arbitrage in the escrow, therefore you lose the full benefit of reduced interest rates. Sure, that 4.2 percent interest rate sounds great, but the fact that you earn 3.5 percent in the escrow takes a bite out of the benefit.

If you have completed a refunding recently, go back and look at whether there was "negative arbitrage" in the escrow, and consider if you were aware of it and its impact on your refunding results.

If you are considering an advance refunding, you deserve to know all of the considerations, both positive and negative. All of these cannot be captured in this short article. There are definitely positives to be gained from refunding, but you need to recognize that there may be more to this "free money" than meets the eye. You deserve to have options explained to you so you understand the full impact of refunding and your alternatives. Do not fall for the "what will your constituents think if they find out you could have saved them lots of money?" and focus on the "what other impacts and considerations should I be aware of?"

I strongly advise you to consider the benefits of an independent financial adviser who can discuss your situation and circumstances and advise on whether or not a specific refunding proposal makes sense for you. Many of you will attend the Washington Finance Officers Association conference in September. I encourage you to watch for the session on refunding bonds to learn more about refunding and how you can position yourself to ask more questions and better questions.

Susan Musselman is financial adviser for the LOCAL program.

Crocker joins LOCAL team

Noah Crocker joined the Office of the State Treasurer in November 2005 as a lease/purchase program specialist.

Noah is a recent graduate of the University of Washington with a bachelor's degree in business, concentrating on finance. Noah will be a real estate specialist for the LOCAL Program.

Noah and his wife, Jenny, are natives of the Olympia area and are excited to be back in the community.

Annual LOCAL financing schedules

Real estate

Cutoff	Funding date	First payment due
Jan. 1	Mid-March	June 1 (year of issue)
April 1	Mid-June	Dec. 1 (year of issue)
July 1	Mid-September	Dec. 1 (year of issue)
Oct. 1	Mid-December	June 1 (following year)

Equipment

Cutoff	Funding date	First payment due
Feb. 1	Mid-March	June 1 (year of issue)
May 1	Mid-June	Dec. 1 (year of issue)
Aug. 1	Mid-September	Dec. 1 (year of issue)
Nov. 1	Mid-December	June 1 (following year)

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